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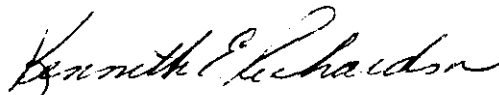
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Docket No. R97-1

ANSWERS OF THE OFFICE OF THE CONSUMER ADVOCATE
TO INTERROGATORIES OF ADVO, INC.
WITNESS: ROGER SHERMAN (ADVO/OCA-T100-1-5)
(FEBRUARY 11, 1998)

The Office of the Consumer Advocate hereby submits the answers of Roger Sherman to interrogatories ADVO/OCA-T100-1-5, dated January 28, 1998. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,



KENNETH E. RICHARDSON
Attorney
Office of the Consumer Advocate

ANSWERS OF OCA WITNESS ROGER SHERMAN
TO INTERROGATORIES ADVO/OCA-T300-1-5

ADVO/OCA-T300-1. On pages 4-5, you state:

"If the Postal Service were to set prices for all mail service subclasses at their marginal costs (represented, say, by accurate volume variable costs), the outcome would be efficient. . . . But a large deficit would result. . . . Such a deficit can be avoided by pricing above marginal cost, but doing so will cause welfare losses. . . . The remarkable property of Ramsey prices is that they minimize the resulting welfare losses."

If postal prices were marked up on the basis of marginal cost (represented by volume variable cost) and then compared to incremental cost, please confirm that the USPS and the Commission could then determine the welfare losses resulting from pricing above marginal cost and could also avoid subsidies between classes and subclasses. If you cannot, please explain why not.

A. Confirmed.

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ADVO/OCA-T300-2. Please refer to your discussion at page 38 on Efficient Component Pricing (ECP) which was first applied to telephone company ratemaking. Assume a telephone company faced strong competition for its long-distance service and was facing competition for some of its local service customers as well. Assume also that local service is characterized by scale cost economies. Under that scenario,

- (a) In developing efficient (welfare-loss minimizing) local service prices, would the company and its regulator subsidize long-distance service with higher rates from local service, parts of which face competition? Please explain.
- (b) In developing efficient (welfare-loss minimizing) local service prices, should the company and its regulator consider the cost and demand characteristics of various categories of local customers, specifically including the group of local customers that may be subject to competitive diversion? Please explain.
- (c) Would it be efficient (welfare-loss minimizing) for local service prices to be the same for all local customers, regardless of their cost and demand characteristics? Please explain.
- (d) Would it be efficient (welfare-loss minimizing) for the company to try to increase contribution to common costs from local customers who were most subject to competitive diversion, and to reduce contribution from local customers who were least subject to competitive diversion? Please explain.

A. (a) There is no reason why the company or its regulator would subsidize long-distance service with higher rates from local service.

(b) Yes, cost and demand conditions influence efficient prices. Optimal pricing in the presence of nonzero cross elasticities, from either a private sector competitor or a complementary service, can be complicated. For example, the positive cross elasticity with a private sector substitute can make the Ramsey price higher than the own price elasticity alone would imply.

(c) If different local services had different cost and demand characteristics, it would probably not be efficient to ignore such information while attempting to set efficient prices. As noted in my answer to (b) above, cost and demand conditions are

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important to efficient pricing.

(d) As noted in my answer to (b) above, optimal pricing when there are nonzero cross elasticities with private sector goods or services (substitutes or complements) can be complicated. It seems unlikely that more contribution should be recovered from customers most subject to competitive diversion, but any answer will depend on the starting point for the analysis and on the other facts of a specific case.

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ADVO/OCA-T300-3. On page 49, you state: "Worksharing has become a significant factor in postal operations and that makes a Ramsey basis for pricing it a very desirable goal." Do you believe that Ramsey pricing should play a role in developing efficient pricing within a subclass?

A. Yes, Ramsey pricing is attractive because it will raise necessary contribution with the least possible welfare loss.

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ADVO/OCA-T300-4. On page 47, you state: "The Ramsey pricing problem for worksharing might be formulated in different ways. One possible way has been discussed so far, to consider single-piece letters and worksharing letters as two services." In implementing such a system,

- (a) Would you envision explicitly estimating separate Ramsey base and discounted prices? Please explain.
- (b) Would USPS marginal costs be measured separately for each service? Please explain.
- (c) Would the marginal costs for non-workshared and workshared mail be separately marked up to determine base and discounted prices, respectively? Please explain.

A. (a) I noted both before and after the quoted passage that there are problems in considering regular letters and worksharing letters as two services. I offered in the next paragraph a formulation in which the single-piece, or base rate would determine the volume of letters and the discount would determine the volume of workshared letters. In that formulation, separate base and discount prices could be sought. The base price for single-piece letter mail could be determined without concern for worksharing. Then the worksharing response of mailers to various discounts would yield a supply elasticity that could be used -- along with information on the cost savings from worksharing -- to determine an optimal discount. Both the base price and the discount could then be obtained by applying Ramsey pricing principles.

(b) USPS marginal cost for letter mail would be used, along with estimates of the cost savings that worksharing would make possible.

(c) With this formulation of the problem, the marginal cost of letter mail would be marked up to obtain the base price. The worksharing discount would be some fraction of the cost savings, which effectively would be passed to mailers in exchange

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for their worksharing. Thus, both regular mailers who paid the base price, and worksharing mailers who received the discount, would make contributions to institutional costs.

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ADVO/OCA-T300-5. On page 50, you state:

"As emphasized by Postal Service Witness Panzer (USPS-T-11, p. 41), cost estimates should be based on a Postal Service operating plan, in order to yield consistent results. Of course, this operating plan may not deal with questions that the estimation of incremental cost invites -- such as the actions that would be taken if First Class Mail was eliminated -- because the operating plan does not extend to such possibilities. While intelligent interpretation of the existing cost system may allow reasonable approximations of incremental costs, limitations of the system need also to be recognized. The cost system was not designed to produce incremental cost estimates, and more attention to this purpose is desirable."

Assume that if First Class Mail were eliminated from the system, the remaining system could be restructured to save additional costs beyond those estimated on the basis of the operating plan. Would incremental cost estimates that ignore such system reconfiguration cost reductions be considered long-run incremental costs? Please explain.

A. The situation described in this question presumes that the operating plan does not fully reflect the savings that might be experienced on eliminating First Class Mail. If that is actually the case, then the operating plan will not reliably support good estimates of long-run incremental costs.

DECLARATION

I, Roger Sherman, declare under penalty of perjury that the answers to interrogatories ADVO/OCA-T300-1-5 of Advo, Inc., are true and correct, to the best of my knowledge, information and belief.

Executed Feb. 9, 1998

Roger Sherman

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.

A handwritten signature in cursive script, reading "Kenneth E. Richardson".

KENNETH E. RICHARDSON
Attorney

Washington, D.C. 20268-0001
February 11, 1998